Internal Revenue Service

memorandum

CC:TL:TS/P
KTROXELL/trs

date: FEB 15 1991

to: District Counsel, Kansas City MW:KCY
Attn: Dale Kensinger

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]
Loans to partnership treated as capital contributions
Partners basis as a partnership item
TL-N-1392-91
CC:TL:TS/P Troxell Sabin
I.R.C. §§ 707(a), 6231(a)

This memorandum is in response to your request for tax litigation advice dated November 16, 1990, for guidance on implementing a proposed partial settlement for this case.

ISSUES

1. Whether a partner's interest free loan to the partnership is a contribution of capital.

2. If so, whether the resulting addition to the partner's basis is a TEFRA partnership item.

3. If the advance is treated as a contribution to capital, how can the proposed Appeals settlement be procedurally implemented.

CONCLUSION

ISSUE 1

A purported loan to a partnership by a partner will be treated as a capital contribution where no valid debtor-creditor relationship exists between the partner and the partnership. This is a question of fact to be determined from all the surrounding facts and circumstances. The substance of the transaction controls, not its form. It appears that no valid debtor-creditor relationship is present between [redacted] and [redacted] and that the purported loan was a capital contribution. However, under the Danielson rule, the Service has the option to hold the parties to the form of the transaction, that is treat the advance as a loan to the partnership by [redacted].

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ISSUE 2

A capital contribution is a partnership item to the extent that it involves legal or factual determinations that: (1) relate to contribution to the partnership; (2) are required to be made by the partnership for purposes of its books and records or for furnishing information to a partner; and (3) are in respect to an amount, the character of an amount, or a percentage of interest in the partnership. If the advance made by [redacted] is treated as a contribution it will be a partnership item as the partnership must determine the amount and character of the contribution for purposes of the partnership's books and records. Further, basis adjustments would be required by the partnership, and each partner. As such, the capital contribution is an item that is more appropriately determined at the partnership level. Lastly, it is important to note that a partner's basis is a partnership item only to the extent that the above determinations need to be made, otherwise it is an affected item.

ISSUE 3

Your proposed procedure to implement the settlement by way of a Stipulation of Settled Issues is generally acceptable. However, we would suggest that the Stipulation address the amount and timing of the contributions and not include the general term "basis". As was stated above, a partner's basis in the partnership is an affected item. It would be improper to stipulate to a partner's basis in a TEFRA proceeding since the Court does not have jurisdiction over affected items in this proceeding. The court does however, have jurisdiction over partnership level determinations that make up basis. Further, we would suggest that the Stipulation contain no mention of the allocation of items of income, loss, deduction, and credit among the partners.

FACTS

[redacted] (herein after "[redacted]"), is a corporate general partner of [redacted] a (hereinafter "[redacted]") a Kansas limited partnership. It is also the tax matters partner of [redacted]. According to the schedule K-1 for the [redacted] and [redacted] tax years [redacted] has a [redacted]% interest in the profits, losses and capital of [redacted]. The Service issued a Notice of Final Partnership Administrative Adjustment (hereinafter "FPAA") to [redacted] for its [redacted] and [redacted] taxable years. In the FPAA, the Service disallowed excessive depreciation deductions and investment tax credits claimed by [redacted]. The FPAA further stated that [redacted] had borrowed money from [redacted], that interest was not paid on the purported loan, that an interest deduction may be allowable on the purported loan, and if a petition were to be filed in the Tax Court, the entitlement to interest deductions could be raised by [redacted].1/

The purported loan was made to the partnership pursuant to the partnership agreement, which provided that [redacted] would loan (or cause to be loaned) sufficient funds to complete the construction of a hotel in [redacted], Kansas. The agreement also provided for loans by [redacted] to ensure sufficient cash flow. The agreement provided that the interest would be at the prime rate announced by Wells Fargo Bank and Trust. [redacted] advanced $[redacted] to [redacted] pursuant to the partnership agreement. [redacted] did not record any interest income from the purported loan and [redacted] did not record any interest expenses on the partnership books. None of the principal of the purported loan was ever repaid.

[redacted] petitioned the Tax Court and raised the issue of their entitlement to interest deductions. Subsequent to the filing of the Tax Court petition, Appeals proposed a settlement of the loan issue to which the petitioners agreed. Under the Appeals settlement, the purported loan would be treated as a capital contribution by [redacted]. [redacted] would have no interest income, but would have an increase in it's basis in [redacted]. [redacted] would not be entitled to any interest deductions. Further, there would be no change in the allocation of income and losses among the partners.

Your question is how to procedurally implement this proposed settlement. You proposed to implement the settlement by filing with the Court a Stipulation of Settled Issues to be signed by [redacted] as the tax matters partner. It will dispose of the interest deduction issue. The stipulation will provide that [redacted] is not entitled to any interest expenses for the years at issue, and it will provide for [redacted]'s contribution to basis. The depreciation and investment tax credit issues will still be before the Court in the proceeding.

1/ The Service's position is based upon sections 482 and 7872. Interest income would be imputed to [redacted] and [redacted] would then be entitled to interest deductions.

ISSUE 1

Generally, transactions between partners and partnerships are governed by I.R.C. § 707. Section 707(a) provides that:

> If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as one between the partnership and one who is not a partner.

Section 1.707-1(a) of the regulations provides that such transactions include loans of money by a partner to the partnership. However, the regulations provide that the transfer of money by a partner to a partnership as a contribution is not a transaction included within the provisions of 707(a). In all cases, the substance of the transaction will govern rather than its form.

Thus, the issue narrows to whether or not this loan is a bona fide loan, and as such will be treated as a transaction between the partnership and a third person, or whether it is "in substance" a capital contribution. A thorough examination of all the surrounding facts and circumstances is necessary to make this determination. Analysis of the relevant facts is aided by the analogy between this "thin partnership" concept and the "thin incorporation" doctrine under corporate tax law.2/ The Tax Court began to apply this approach in the case Hambuechen v. Commissioner, 43 T.C. 90 (1964). In Hambuechen, the court held that where it is necessary to determine whether an advance by a partner to a partnership is a loan, factors used in thin corporation cases can be used for analysis. Id. at 102. The court stated that whether or not a particular transaction, for tax purposes, creates a valid debtor-creditor relationship, or is in reality a contribution to capital, is essentially a question of fact to be determined from all the surrounding facts and circumstances. Id. The taxpayer has the burden to establish the

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2/ The Service is generally in accord with the "thin partnership" theory. See GCM 36,702, I-415-74 (April 12, 1976). See also Rev. Rul. 72-135, 1972-1 C.B. 200. (non-recourse loan by general partner to a limited partnership held to be a capital contribution) However, it is not widely used due to the more powerful weapons against tax shelters (ie. §§ 183, 465, 469) provided by Congress. For more discussion on this concept See McKee, Nelson and Witmire, Federal Income Taxation of Partnerships and Partners § 7.02 (1990); Plumb, The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 Tax L. Rev. 369 (1971). [Hereinafter "Plumb"].

debtor-creditor relationship. Id. The court further stated that the substance and not the form of the transaction is controlling and accordingly the taxpayer's motive, though a factor, is not the crucial one.3/ Id. The Tax Court in Hambuechen set forth the various factors used to determine whether or not a debtor-creditor relationship has been established. Id. at 99. They are as follows:

(a) whether or not a promissory note was issued,

(b) the adequacy of capitalization of the partnership,

(c) whether or not there was provision for and payment of interest,

(d) whether or not there was a maturity date,

(e) the presence of an intention to repay by the debtor,

(f) whether or not the debt is subordinated to the claims of outside creditors,

(g) whether an outside creditor would have made similar advances under the same circumstances,

(h) the presence or absence of security of the alleged loan,

(i) the reasonableness of expectations of repayment,

(j) whether payment can only be paid out of future profits,

(k) use to which the funds are used.4/

The court stated that the essential difference between a creditor and a contributing partner is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event. Id. at

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3/ It is important to note that the Service has the option of holding the parties to the form of the transaction. See Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967), cert. denied, 389 U.S. 858 (1967), where the court said: In construing the terms of a contract to determine the tax consequences, if the terms of the contract are clear and unambiguous, the Commissioner reserves the right to bind the parties firmly to those terms unless proof is introduced that shows unforceability of the contract.

4/ This factor was added by the court to the analysis in the case of Kingby v. Commissioner, 46 T.C. 147, 159 (1966).

99. No one of the listed factors by itself is determinative of the question. Id.

In the present situation there was no promissory note for the advance made by [redacted] to the partnership. However, the partnership agreement did provide specific references to the purported loan transaction. These references are as follows:

> § 13 <u>Commitments and Guarantees of the Limited Partner (Special General Partner Loans)</u>
>
> A. ...[T]he General Partner does hereby guarantee to the Limited Partners the lien free completion of the [redacted] Project, ... the General Partner does hereby agree to lend or cause to be loaned to the Partnership the additional funds necessary for such completion.
>
> B. ...[[redacted]] does hereby agree that it shall advance or cause to be advanced to the Limited Partnership as a loan such funds as may be necessary to ensure that during each Partnership fiscal year the Partnership will not have a negative cash flow of available cash.
>
> C. ...[[redacted]]...shall postpone the collection of all of such part of its management fee due under its Management Agreement.... to the extent that such payment.... reduces... the positive flow of available cash below zero. Any such postponement of management fees shall only for the purposes of this agreement be considered a loan made by the General Partner to the Limited Partner.
>
> D. Any such loans shall bear interest at the Prime Rate.
>
> The agreement further provided:
>
> 3. <u>Definitions And Glossary of Terms</u>
>
> 3.25 "Partner loan" means any monie (sic) loaned the Partnership... by a Partner, including without limitation monies loaned or deemed to have been loaned by the General Partner under Paragraph 13....
>
> 3.31 "Prime Rate" shall mean the prime rate of interest announced on charged from time to time by the Wells Fargo Bank and Trust Company of San Francisco to its most credit worthy corporate customers for ninety day unsecured loans.

The factors expressed in Hambuechen can be restated in three general categories. They are: (1) the factors surrounding the transaction; (2) the intent of the parties; and (3) the "reasonable lender" test.

In scrutinizing the transaction, it is clear that no promissory note was ever issued. The issuance of a promissory note is one of the factors the Court will look at in determining whether this is a loan or a contribution to capital. The partnership agreement provisions that relate to the loan are probably insufficient to replace a promissory note. The agreement does not contain the normal provisions that are included in such a note.5/ The partnership agreement does provide for the payment of interest, however, none was ever paid to [redacted] by the partnership. Although not expressly subordinated to outside creditors, these advances would certainly be subordinated to secured creditors and judgment creditors. Also, as it stated in the agreement, [redacted] would have no recourse against the partners through the principal partnership asset since they agreed to complete the project lien free. This also shows that there is, in substance, no security for the purported loan. The surrounding circumstances of the transaction strongly support the proposition that the purported loan was "in substance" a contribution.

In looking at the intent of the parties it appears that the partners wanted to treat the advance as a loan. However, as the Hambuechen court stated, and the regulations provide, the substance of the transaction controls. The intent of the parties, although a factor, is not a crucial one. [redacted] did not fully treat the advance as a loan as they never demanded or recorded any interest income and merely reported the advance on the corporate books as an account receivable. [redacted], in turn, did not claim any interest deduction and recorded the purported loan as an account payable. The advance was used for the completion of the [redacted] and thus was used for the partnership's only capital asset.

The last relevant category of th Hambuechen factors is the "reasonable lender" test. This was stated by the court as whether or not an outside creditor would have made similar advances under the same circumstances. The answer to this is

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5/ Plumb, 26 Tax L. Rev. at 461-62. Generally a creditor would execute a promissory note that complies with U.C.C. § 3-104. The requirements are that there be a signed writing, with a promise to pay a sum certain on demand or at a definite time, payable to order or bearer. Here the partnership agreement would not appear to serve as a note under reasonable commercial practices.

probably no. An outside creditor would have most likely executed a simple promissory note to secure his legal rights. He would not have given up any recourse rights against the partnership property, as [redacted] did, and would have probably filed a security interest in any perfectible partnership property. An outside creditor would have demanded more definite terms of payment and accrual of interest on the principal of the loan.

The advance made by [redacted] to the partnership appears to be a capital contribution under the Hambuechen analysis, and therefore, would not be a 707(a) transaction. As such, a basis adjustment to [redacted]'s basis under § 722 would be required in the amount of the advance. Further, the other partners may have a potential basis adjustment if they included his or her share of the purported loan in their partnership basis pursuant to § 752(a). It is important to note here that in treating this advance as a capital contribution, problems may arise for [redacted] for this taxable year, as well as in the future. This is due to the disparity in the amount of the actual contributions in relation to the allocation of income and losses stated in the partnership agreement. Since these allocations will not change due to the proposed settlement agreement, but the amount of each partner's contributed basis will change, [redacted] may have to justify these "special allocations" under § 704(b) (ie. that the allocations have substantial economic effect. See Treas. Reg. § 1.704-1(b)).

ISSUE 2

If the advance is treated as a capital contribution, this is determinative of the issue of whether or not the addition to basis is a "partnership item", an "affected item", or a "nonpartnership item". Section 6231(a) of the Internal Revenue Code provides that a "partnership item" is:

> Any item required to be taken into account for the partnerships taxable year under any provision of subtitle A to the extent the regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

Section 6231(a)(5) provides that:

> The term "affected item" means any item to the extent such items is affected by a partnership item.

Section 301.6231(a)(3)-1(a)(4) of the temporary regulations provides for the treatment of capital contributions. This regulation provides that a capital contribution is a partnership item to the extent that it involves legal or factual determinations that relate to the contribution. Specifically the determination is a partnership item if the determination: (1) relates to contributions to the partnership; (2) is required to be made by the partnership for purposes of its books and records or for furnishing information to a partner; and (3) is in respect to an amount, the character of an amount, or a percentage interest in the partnership.

Section 301.6231(a)(3)-1T(c) provides that the critical element in determining whether an item is a partnership item under paragraph (a)(4) is whether the partnership needs to make a determination, not whether the partnership actually makes the determination. This section provides an example on the issue of contributions. It states that for purposes of its books and records, or for furnishing information to a partner, the partnership needs to determine the character of the amount and the amount received from a partner (for example whether it is a contribution or a loan). _See_ Temp. Treas. Reg. § 301.6231(a)(3)-1T(c)(2).

Clearly, if the purported loan is treated as a contribution it is a partnership item as it is an item that is more appropriately determined at the partnership level. The re-classification of the purported loan as a contribution will cause several determinations and adjustments to be made by [redacted]. First, it must decide the character and the amount of the contribution. Second, it must adjust it books and records as to each partner relative to the contribution. Third, it may have to redetermine the relative partner interests in the partnership. Pursuant to Temp. Treas. Reg. § 301.6231(a)(3)-1T(c), the advance made by [redacted] is a partnership item to the extent the partnership needs to make the above determinations.

However, it is important to note that the partners' bases will be partnership items only to the extent that the above determinations need to be made. Otherwise, a partner's basis in a partnership is generally an affected item. _See_ Temp. Treas. Reg. § 301.6231(a)(5)-1T(b); _Dial USA, Inc. v. Commissioner_, 95 T.C. No. 1 (July 2, 1990).

ISSUE 3

The procedure you proposed to implement the settlement is generally acceptable. However, we would suggest the following changes to the Stipulation of Settled Issues.

In paragraph 1(a) we would state that [redacted] made capital contributions to [redacted]. The amounts and the applicable years at issue should also be included in the Stipulation. We would not use the word "basis" in the stipulation since, as was stated above, a partner's basis is an affected item. It would be improper to include a partner's "basis" in a Stipulation in a partnership proceeding. The court does not have jurisdiction over affected items in this proceeding. However, the Court does have jurisdiction over the partnership level determinations which make up basis.

We also suggest that paragraph 1(b) be stricken from the stipulation. We are aware of the fact that the petitioners most likely do not want the allocation of income, deductions, loss, and credits to change due to the contribution. However, we feel that the stipulation is not necesary since the partnership agreement provides for the allocation of losses and deduction amoung the partners. Under I.R.C. § 704(a), a partners distributive share of income, loss, deduction, and credit is normally determined by the partnership agreement unless those allocations lack substantial economic effect under I.R.C. § 704(b)(2). If the allocations have substantial economc effect, in light of the new contribution, then the stipulation is not needed. However, if the allocations do not have substantial economic effect then they must be reallocated among the partners pursuant to Treas. Reg. § 1.704-1(b). Further, on the assumption that a reallocation would need to take place, if paragraph 1(b) was included in the Stipulation the Service would potentially only have one year to assess these allocations under I.R.C. § 6229(f). Therefore, our opinion is that paragraph 1(b) should not be included in the stipulation.

In your memorandum you also stated that Appeals will resolve the interest income issue with [redacted] as a nonpartnership item. We are unclear as to what you mean by this. It is our opinion that the characterization of the advance as a loan will dispose of any need to address the issue of interest income under section 7872, or the reallocation of that income under section 482. Note, that for purposes here we are not addressing the issue of whether section 482 and section 7872 adjustments are partnership items or affected items.

If you should have any questions please contact Keith Troxell at FTS 566-3233.

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